The Tax Cuts and Jobs Act (TCJA) of 2017, the most significant revision to the U.S. tax code since 1986, reduced the headline corporate tax rate from 35% to 21%. Businesses have already responded to the fiscal stimulus, which was designed to make the country more competitive within the global marketplace. Apple recently announced a plan to invest $350 billion in the U.S. over five years that includes creating 20,000 jobs and building a new corporate campus. However, corporations are not the primary beneficiary of tax reform. The average per household tax savings is estimated to exceed $1,600 in 2018 alone. In terms of cumulative savings, households could see a net benefit three times greater than that of employers over 10 years.\(^1\)

Tax reform will likely raise consumer spending, employment levels, business investment, and wage growth. By early January 2018, more than 80 companies operating within the U.S. had announced wage hikes. The TCJA is expected to boost annual real gross domestic product (GDP) growth by 0.3% in both 2018 and 2019.\(^2\) We believe that new tax legislation could extend the current business cycle by a few years and that current consensus expectations of the new tax code’s stimulative effects upon the economy are overly conservative.

However, the potential downside risks from this deficit-funded stimulus should not be ignored. The introduction of tax cuts when the labor market is at full employment may lead to inflationary pressure, which could spur the Federal Reserve to raise interest rates more quickly than it otherwise would have. Rising long-term borrowing costs are also a concern, as the TCJA could add another $1 trillion to the U.S. public debt load, which is already over 100% of GDP – its highest level in 50 years.\(^3\) We believe these risks should remain in check as interest rates will likely stay low over the long-term due to the deflationary pressures associated with the global savings glut, ongoing technological innovation, and weakening demographic trends.

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*Past performance is no guarantee of future results. All investments involve risk including possible loss of principal.*

**INVESTMENT PRODUCTS: NOT FDIC INSURED * NO BANK GUARANTEE * MAY LOSE VALUE**
Potential Impacts of Tax Reform

<table>
<thead>
<tr>
<th>Short-Term (1-4 years)</th>
<th>Long-Term (5-10 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Boost business, consumer confidence (“animal spirits”)</td>
<td>1. Increase U.S. competitiveness in the global marketplace</td>
</tr>
<tr>
<td>2. Spur more consumer spending</td>
<td>2. Bring some overseas operations back to the U.S.</td>
</tr>
<tr>
<td>3. Faster GDP growth (= +0.3% in 2018, 2019)</td>
<td>3. Increase domestic manufacturing production</td>
</tr>
<tr>
<td>4. Higher wage growth</td>
<td>4. Strengthen corporate credit</td>
</tr>
<tr>
<td>5. More capex spending, higher demand for new office space</td>
<td>5. Deficit-funded fiscal stimulus</td>
</tr>
<tr>
<td>6. Higher inflation</td>
<td>6. Add $1 trillion or more to the U.S. national debt load</td>
</tr>
<tr>
<td>7. Fed raises rates more quickly than expected</td>
<td>7. Raise borrowing costs</td>
</tr>
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</table>

Favorable Treatment for Commercial Real Estate Under the New Tax Regime

To the broad relief of the industry, commercial real estate emerges as a clear winner from tax reform. The industry maintains favorable treatment, as many of the provisions regarding real estate investment/ownership have been preserved or have become more favorable:

- Like-kind exchanges (aka 1031 exchanges) for real property are preserved.
- Interest deductibility for property is unchanged, although election will impact depreciation.
- Offshore corporate investors subject to the Foreign Investment in Real Property Tax Act (FIRPTA) are eligible for reduced withholding on real estate investment trust (REIT) capital gains distributions attributable to the sale of domestic real property.
- Both public and private REIT dividends are taxed at a lower rate for domestic investors.
- Low-income housing tax credits are preserved.
- Individual investors in real estate partnerships may be eligible for a reduced effective tax rate on their share of income.

Coming at a time when consumer and business confidence are high, the cash savings due to the TCJA will likely be spent rather than saved, unlike prior instances of government stimulus. Tax reform should therefore act as a ‘direct injection’ into the economy and labor markets. This has brightened our demand outlook for 2018 and 2019, because real estate owners and investors should benefit from the resulting influx of capital, which will help drive income growth and value appreciation.

Consumer and Business Confidence at Cyclical Highs
Tax Reform Benefits by Property Sector

Industrial

Higher consumption spending should further boost record demand for industrial warehouse space. The sector is already the best performing of the NCREIF Property Index (NPI) over the last five years and will experience additional tailwinds resulting from tax reform that could extend its dominant return performance. Investor focus on infill ‘last-mile’ facilities has picked up, although appetite for big-box warehouse space remains elevated as e-commerce continues to revolutionize the purchase and delivery of consumer goods. As households and businesses spend more, the share of retail sales will continue to shift in favor of e-commerce over physical stores. Even prior to the passage of new tax legislation, industrial vacancy was at record lows across most markets, justifying low cap rates due to high expected rent growth. With the boost from tax reform, tenant demand could rise further, keeping supply and demand fundamentals favorable even in markets with active construction pipelines.

Apartment

Nationally, higher discretionary income from tax savings will likely translate into an increased capacity to pay higher rents. One of the most controversial provisions of the tax act deals with the cap on State and Local Tax (SALT) deductions of $10,000 and the $750,000 cap on mortgage interest deduction. High-cost for-sale housing markets in coastal gateway metros will be the most impacted. In an analysis of mortgages and property taxes across more than 1,700 counties nationwide, Attom Data Solutions found that three out of the top five counties with the most home loan originations above $750,000 are in Southern California and the Bay Area. Three of the top five counties with the most homes paying property taxes above $10,000 are in the New York/New Jersey area. Housing prices in high-cost metro areas are likely to readjust, as the tax incentives for homeownership have been reduced. This disruption to the for-sale housing market could give first-time homebuyers pause. Therefore, we expect marginally higher demand for rental housing over the near-term.

Office

With more cash on their balance sheets, many firms are in a better position to buy, renovate, or build better office space. Overall, however, demand will likely be uneven for the office sector. Traditional users remain under pressure as office employment growth continues to moderate, although this trend could stabilize over the coming years as the result of increased business investment. Nonetheless, the co-working space-use paradigm that attempts to foster collaboration and efficiency will continue to shrink tenant footprints. Fortunately, tenants are investing in construction of new space and redevelopment, even at a considerably higher price point per square foot. ‘Creative’ office and co-working layouts are highly sought after, and ‘bite-sized’ office redevelopment or ground-up construction may be an attractive risk-adjusted opportunity due to a shorter development timeframe and manageable scale.

Retail

In recent years, the excellent dynamics of the industrial property sector have come at the expense of retail. Even with 2017’s strong holiday sales growth, the trend towards store rationalization continues as retailers rush to build out their omni-channel platforms to accommodate the growing proportion of online sales. Recently, Walmart announced wage hikes for its hourly employees, but also moved to close 10% of its Sam’s Club stores. Consumer households may not be more inclined to spend in a store, even with their tax savings, and we do not expect retailers to accelerate store openings or slow store closings simply because of tax reform. However, retailers have long complained that the tax code puts them at a disadvantage relative to other firms, both domestically and abroad. The National Retail Federation reports that retail is the most heavily-taxed industry, owing to the lack of loopholes that other firms take advantage of and the high percentage of retailers that are small businesses. Tax reform should help level the playing field and moderate the rapid shift of shopping from physical stores to online channels.
Conclusion

The benefits of tax reform to the economy and the commercial real estate industry will continue to unfold over the current year. We do not expect tax reform to reverse or reshape the trends resulting from long-running demographic, economic, and technological shifts. Rather, the knock-on effects of tax reform should reinforce and amplify the secular trends already underway across space markets. Some regions will make out better than others, but we are optimistic that, overall, the strong momentum generated by the passage of the TCJA will carry the commercial real estate industry through the next few years.

<table>
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<tr>
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<th>2016</th>
<th>2017</th>
<th>2018F</th>
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<tbody>
<tr>
<td><strong>U.S.</strong></td>
<td>1.6%</td>
<td>2.3%</td>
<td>2.7%</td>
</tr>
<tr>
<td><strong>Global</strong></td>
<td>3.1%</td>
<td>3.2%</td>
<td>3.7%</td>
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</tbody>
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Source: Bloomberg consensus estimates, February 2018

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